

General Information Letter: Application of Public Law 86-272.

February 6, 1998

Dear:

This is in response to your letters dated January 27, 1998 and incorporating your letter of November 12, 1997 in which you request a letter ruling. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department.

Although you have not specifically requested either type of ruling, the nature of your question and the information provided require that we respond only with a GIL.

In your first letter dated January 27, 1998 you stated:

We previously sent to Mr. Keith Staats, Associate Chief Counsel, a letter dated November 12, 1997 (copy enclosed) requesting a nexus determination on behalf of our client, Company 97-1997 (copy enclosed) requesting a nexus determination on behalf of our client, Company 97-ABC ("Company"). In that letter, we indicated that we believe Company is protected from filing corporate income tax returns in Illinois pursuant to P.L. 86-272. We requested a written determination from the state of Illinois in order to provide additional assurance to our client.

Our request was subsequently forwarded to Mr. Charles Matoesian, Staff Attorney, for review. Mr. Matoesian sent me a response dated November 18, 1997 (copy enclosed) stating that Company is not protected from Illinois Income Tax liability under P.L. 86-272 because we have not established that its members are independent contractors as defined in the law. I spoke with Mr. Matoesian today about this matter. After some discussion, I agreed to send him some additional information about the Company and offered to submit this proposal to you for your consideration.

I have pursued this nexus analysis with many states. So far, I have received written responses from 17 states which have concluded that this Company is protected from income tax filing requirements in their states pursuant to P.L. 86-272. Other states are willing to accept our proposal because they do not believe the amount at issue for prior years is worth a detailed nexus analysis. Although I appreciate Mr. Matoesian's analysis of this nexus issue, apparently reasonable minds can differ to this area of the law. There are not many court decisions to guide us.

Even though we believe Company is protected from filing income tax returns in Illinois, we recognize that the parameters of the protection offered by P.L. 86-272 are somewhat gray and subject to change with subsequent court decisions or changes in the Company's activities in Illinois. Company is growing and desires to be prudent and avoid accumulating potential income tax exposure for the future. Consequently, if there is any question about the Company's protection for filing income tax return, Company and its shareholders are willing to file and pay income tax to Illinois on a prospective basis if the state of Illinois is willing to agree not to audit Company and its shareholders for prior years.

Company has been making sales only since 1995 and does not have substantial past exposure. I have estimated that, assuming Company is not protected by P.L. 86-272, the total apportioned income tax liability for Company and its shareholders for the years 1995 through 1997 would be approximately \$31,000. There is approximately \$200 of estimated franchise tax for each year, 1996 and 1997.

Given the limited dollars at issue here, and the uncertainty in this area of the law, and because the Company desires to resolve this issue as expeditiously as possible, I propose that we enter into an agreement by Illinois that it will not pursue Company or Company shareholders for income tax, franchise tax, interest or penalties for years prior to 1998. Under the circumstances of this case, we believe this would be an equitable and efficient way to resolve this issue. In order to expedite the resolution of this matter, I have enclosed a draft of an agreement I am using with other states.

In your second letter dated January 27, 1998 you stated:

I received your letter dated November 18, 1997 stating that our client, Company 97-ABC ("Company") is not protected from Illinois Income Tax liability under P.L. 86-272 (codified at 15 USCS @381) because Company has not shown that its members are independent contractors within the meaning of that term in P.L. 86-272. You point out that in order for a company to be protected by P.L. 86-272, its agents must solicit orders for the sale of tangible personal property for more than one principal and, secondly, the agents must hold themselves out as independent contractors in the regular course of their business activities.

We believe that the Members of the Company can rely on the protection afforded by Subsection "a" of 15 USCS @381 which allows a person to solicit sales in your state and the state may not impose a net income tax on the income of such sales. Members solicit sales of products of Company on behalf of Company. Such activities are clearly protected.

As we discussed on the telephone, the Company has many members and cannot possibly know whether they all sell products of other companies. However, I want to point out that the members purchase products from Company which they either use themselves or resell. Most of the products (approximately 90%) which members purchase from Company are for their own consumption. The members may purchase products from Company at wholesale prices and resell these products to consumers at the suggested retail price. Company does not control the resale price for, or the frequency of, these sales. Thus, to the extent Members resell products, the Members are not selling products "on behalf of" Company. Rather, the Members are purchasing products for their own retail businesses and reselling products as an independent distributor. Members may not return products which they are unable to resell or do not want for their own consumption. Because members are not making sales "on behalf of" Company, we need not rely on the additional protection afforded by subsection "c" of 15 USCS @381. Consequently, the Members need not fall within the strict definition of "independent contractor" within this law.

We believe that Company is protected from income tax filing requirements in Illinois. We have received many responses from other states that have agreed with our conclusion that Company is protected from income tax filing requirements pursuant to P.L. 86-272.

Along with this third letter was a sample letter and proposal addressed to Mr. Tom Phillips at the Kansas Department of Revenue.

Discussion

Your letter involves three issues:

1. Does Company meet the requirements of P.L. 86-272 so as to avoid Illinois taxation.
2. Will Illinois agree to forego auditing company for prior tax years if the company agrees to begin paying taxes for tax years 1998 and beyond.
3. Can the agreement in question 2 be extended to cover the franchise tax as well as the income tax.

When viewing your letters together, I think you are asking for more than the Department can grant. The Department does not issue private letter rulings (which are binding on the taxpayer in question) on the issue of nexus. Such a determination may only be made in the context of an audit where the Department's auditor would have access to all relevant facts and circumstances and the taxpayer is identified.

Accordingly, only general guidance concerning Illinois law and policy can be given by the Legal Department. With this in mind, Public Law 86-272 provides:

[f]or purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or more independent contractors, whose activities on behalf of such person in such state consist solely of making sales, or soliciting orders for sales, of tangible personal property.

15 USCA §381(c). By contrast, a taxpayer who conducts activities in a state through representatives who are not independent contractors is not protected if the representatives do more than solicit orders for tangible personal property. See §381(a).

The third letter concerning your client seeks the protection of 15 USCA §381(a). Fifteen USCA §381(a), is clear concerning the limited duties allowed of representatives in order for protection to be granted by the statute. Section 381(a) states:

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph(1).

In your first letter, you state" [m]embers solicit individuals into their network to purchase products and are paid commissions by Company, based on the purchases of products by other Members in their network." This activity, by soliciting other members rather than tangible personal property, and involving commissions for this activity exceeds §381(a) protection and indeed exceeds §381(c) protection as well.

Beyond this topic, the third letter seems to state facts somewhat different than the first letter in that the first letter states that "[o]rders for products...are submitted to Company's home office...for credit approval, processing and shipment...[m]embers do not collect payment for products on behalf of the Company", while the third letter indicates that "[c]ompany does not control the resale price for, or the frequency of, these sales. Thus, to the extent Members resell products, the Members are not selling products 'on behalf of' Company." Because the facts are not clear, and since the issue of nexus is very fact-specific, the Department must refrain from issuing an opinion of the facts.

The second, and perhaps more important question from your perspective, concerns the possibility of an agreement to begin reporting Illinois income taxes in tax year 1998 in return for which Illinois will refrain from auditing Company for prior years. The Department is unable to enter into an agreement of this nature. Illinois has voluntary disclosure regulations, found at 86 Illinois Administrative Code Ch. 1, §210.216 copy enclosed, which limits the Department's ability to engage in these negotiations. More specifically, under the regulations the taxpayer must disclose all tax liabilities, file returns and pay such liabilities for the past four years. After the taxpayer has complied with the regulations, the Department will not pursue liabilities for years prior to the four years covered by the filed returns. As your client only began selling it's products in Illinois in 1995 this arrangement may not be of great use to you, but we cannot grant you any better terms.

The third question your letters raise concerns whether franchise taxes are covered by P.L. 86-272. The franchise tax is not administered by the Department of Revenue, but by the Secretary of State. You may wish to contact the Secretary of State at the following address:

The Honorable George Ryan
Secretary of State
Business Services Department
Howlett Building, Room 328
Springfield, IL 62756

You should also be aware that if your client is a corporation §502(a)(2) of the Illinois Income Tax Act requires that a corporation which is authorized to do business in this State, and is required to file a Federal income tax return, will be required to file an Illinois income tax return regardless of whether the corporation is liable for Illinois income tax (See IITA §502, copy enclosed).

I hope that this information has been helpful to you, and if I can be of further service, please let me know.

Sincerely,

Charles E. Matoesian
Staff Attorney (Income Tax)

